SUMMARY OF THE REGULAR MEETING OF THE ARIZONA STATE RETIREMENT SYSTEM INVESTMENT COMMITTEE

HELD ON

Wednesday, March 7, 2008
12:00 p.m.

The Investment Committee (IC) of the Arizona State Retirement System (ASRS) met at 3300 N. Central Avenue, 14th Floor Conference Room, Phoenix, Arizona 85012. Mr. Lawrence Trachtenberg, Chair of the IC, called the meeting to order at 12:04 p.m., Arizona Time.

The meeting was teleconferenced to the ASRS Tucson office, 7660 East Broadway Boulevard, Suite 108, Tucson, Arizona 85710.

1. Call to Order; Roll Call; Opening Remarks

Present: Mr. Lawrence Trachtenberg, Chair (via teleconference)
Mr. Christopher Harris
Mr. Thomas Connelly
Mr. James McLaughlin

A quorum was present for the purpose of conducting business.

Mr. Thomas I. McClory, Assistant Attorney General, noted that Mr. Dave Byers, ASRS Board Trustee, was present as a non-participating observer, not as a trustee and, therefore, the IC did not constitute a Board Meeting.

2. Presentation, Discussion, and Appropriate Action Regarding the BlackRock Financial Management's Mortgage Investors Fund

Mr. Lawrence Trachtenberg introduced the topic. Mr. Gary R. Dokes, Chief Investment Officer (CIO), said staff recommends the BlackRock Financial Management's Mortgage Investors Fund which is designed to take advantage of existing and developing tactical opportunity in the securitized mortgage market. The BlackRock Mortgage Investors Fund was created to capitalize on opportunistic, short-to-intermediate market dislocation. Staff feels BlackRock has the ability to recognize value, manage risk, and is comfortable with their fixed income investment platform.

Mr. Dokes said the ASRS real estate program has already taken advantage of some market dislocation opportunities, having invested $50 million in Five Mile Capital and $100 million in LoneStar. In the private equity program, $140 million has been committed to Wayzata.

Mr. Brian Luedtke, ASRS Fixed Income Portfolio Manager, stated that BlackRock has the technology and procedures to evaluate and managed mortgage securities. Blackrock foresees a final portfolio consisting of approximately 1/3 asset-back securities and 2/3 securities backed by residential mortgages. De-leveraging is providing tactical mortgage investors with good buying opportunities. BlackRock is expected to employ leverage of approximately 1.2-1.5x capital. The Fund is expected to achieve net returns in excess of 14%.

Mr. Dokes commented that the BlackRock Mortgage Investors Fund will be classified in the Opportunistic Asset Class given the tactical nature of the investment. Per the ASRS Strategic Asset Allocation Policy, Opportunistic Asset Classes include investment opportunities that do not fall into clearly-defined asset classes, take advantage of changing and tactical market conditions or are driven by perceived changes in the relative values of various asset classes.

Mr. Dokes said that due diligence has been conducted by staff, Townsend (ASRS Real Estate consultant) and Mercer (ASRS General Investment consultant). In addition, the CIO/staff discussed the Fund in detail with Pennsylvania Public Schools, a large investor in the Fund.

Mr. Terry Dennison, Mercer, commented on his comprehensive analysis. The rating is B+ and Mercer would not be uncomfortable with a recommendation to invest up to $75 million. BlackRock understands this area of the market very well and has good risk management capability. Part of the reason the overall rating is not A, is their process is quantitative and the unusual market conditions may not fit what quantitative models have seen before.

Mr. Trachtenberg wondered if there was a built-in mark to market downward. Mr. Dokes said the ASRS would pay a buy-in fee going back to the initial close date in November 2007, which is normal for these funds, as it also is for private equity funds.

Mr. James McLaughlin asked Mr. Dennison about his recommendation to proceed cautiously. Mr. Dennison said there is risk but this is one of the most efficiently priced funds in the market. He explained that the note of caution was not associated with proposed $75 million ASRS investment size but with the general risk profile that exists in the mortgage market.

Mr. Christopher Harris asked if there are funds with higher ratings, why Mercer did not bring some of them to us for consideration. Mr. Dennison does recommend that the IC ask staff to look at other funds so as to spread out available market dollars among various tactical funds. Mercer sees BlackRock as a significant opportunity. Mr. Dokes said staff has been focusing on about six tactical opportunities in the past two months.

Mr. Mark Warner and Mr. Rob Capaldi, BlackRock, joined the meeting via phone. They gave their perspective on the state of the market and explained how they determine value. They are looking to take advantage of force sales of mortgages. Deleveraging in the market has brought BlackRock closer to finding deals that meet return targets without the use of any or much leverage.

Mr. Harris asked about mark to market value versus the cost of $600 million cost basis on assets pre-specified. Mr. Warner said it is currently $673 million. Total Fund returns are probably down about 1.7% on drawn capital for the period of mid-December to end of February as market continues to cheapen. Mr. Luedtke said there is an 8% preferred return, 20/80 catch up, 80/20 beyond that, with an interest payment of 10% on the 40% that has been drawn. Mr. Paul Matson, Director, asked BlackRock if on a mark-to-market basis the Fund was down in value and accrued interest by about 3% since inception and has about 60% capital in reserve to take advantage of lower prices. BlackRock confirmed that that estimate is correct.
Mr. Harris asked about BlackRock's Fund target size of $1 billion. BlackRock said the Fund is hard-capped at $2 billion and has commitments of $1.7 billion. Mr. Harris further asked about

GP commitments; BlackRock, Inc. has committed $50 million and employees of the firm and management team have committed close to $10 million.

Mr. Dokes said he is comfortable with an ASRS commitment amount of $75 million or $100 million. Mr. Dennison is more comfortable at $75 million, due to there being so many other opportunities to consider. Mr. Trachtenberg is comfortable with $75 or 100 million.

Mr. Dokes said the ASRS will have an advisory seat on the Fund if the decision is made to invest.

Motion: Mr. Harris moved that the IC recommend the following to the Board for approval:

- Invest $75 million in the BlackRock Mortgage Investors Fund; funding from BGI's Enhanced U.S. Debt Index Fund.
- Classify and report the BlackRock Mortgage Investors Fund as an Opportunistic Asset Class within ASRS Asset Allocation Policy.

Mr. Thomas Connelly seconded the motion.

By a vote of 4 in favor, 0 opposed, and 0 absent, the motion was approved.

3. Presentation and Discussion, and Appropriate Action Regarding the ASRS Global Tactical Asset Allocation (GTAA) Manager(s) Search

Mr. Trachtenberg introduced the topic. Mr. Dokes said the ASRS GTAA Search Committee recommends hiring Deutsche Asset Management and Mellon Capital Management as ASRS GTAA managers, funding both managers with approximately $500 million from the BGI GTAA passive portfolio. The GTAA Search Committee consisted of an IC member, Director, CIO, Investment Management Division (IMD) staff, and Mercer (general and GTAA specialist).

Mr. Dokes covered the background leading to the GTAA search which noted that Mercer and IMD staff recognized that, in general, GTAA managers' investment approach over the past 12-18 months had changed as they endeavor to generate increasing alpha by investing outside the ASRS benchmark asset classes and adopting complex trading strategies. In short, GTAA manager candidates possessed characteristics similarly to hedge fund offerings, with lack of transparency, high incentive fees, and an absolute return strategy rather than benchmark performance orientation. Given ASRS preference to hire GTAA managers who generate alpha primarily by tactically over- and under-weighting asset classes consistent with those in ASRS strategic asset allocation policy, the search was focused on identifying GTAA managers who have the expertise and willingness to manage a GTAA mandate based on ASRS' individual benchmark and GTAA constraints. Of the seven (7) short-listed candidates initially identified, three (3) were interviewed and two (2) were selected for recommendation to the IC.

Mr. Dokes recognized that Mr. Dan Kapanak, ASRS Manager of Investment Strategy, has a very good understanding of GTAA and that Mercer is very strong in GTAA.

Mr. Kapanak said the two recommended GTAA managers have differing styles. Mellon Capital Management believes in departures from equilibrium to create opportunity. One of Mellon's key strengths is risk management. Mr. Kapanak noted Deutsche Asset Management has an integrated platform which uses a multi-team strategy to find value as they combine their views into an optimal portfolio. Mr. Kapanak commented that Deutsche's key strength is their diversification. They are looking for teams with low alpha correlations. Mellon and Deutsche have a similar risk budget allocation.

Mr. Dennison stated Mercer feels the ASRS staff chose the best two managers out of the search process. He strongly supports the Search Committee recommendation.

Mr. Harris asked why not equally fund each of ASRS three (3) GTAA managers? Mr. Dokes said the Search Committee is comfortable with Bridgewater's style and the amounts recommended. Mr. Trachtenberg said he had preference to wait a year to see performance results from Mellon and Deutsche moving funds from Bridgewater to DB and Mellon Cap. Mr. Kapanak noted Bridgewater is the most diversified of the three managers.

Motion: Mr. Connelly moved to recommend that the Board:

- Hire Deutsche Asset Management and Mellon Capital Management as ASRS GTAA managers.
- Fund both managers with approximately $500 million from the BGI GTAA passive portfolio.

Mr. Harris seconded the motion.

By a vote of 4 in favor, 0 opposed, and 0 absent, the motion was approved.

4. Presentation, Discussion, and Appropriate Action Regarding the ASRS Investment Management Governance Structure, Decision-Making Processes, and Investment Committee Charter

Mr. Dokes said the purpose of this item was to synthesize the discussion occurring at the February 6, 2008 IC Meeting and to facilitate additional discussions with the IC regarding the ASRS Investment Management Governance Structure, Decision-Making Processes, and Investment Committee Charter.

The four thematic investment management governance related topics are: 1) Hiring and termination of traditional and alternative ASRS Investment Managers, 2) Asset Class Committee(s) Voting Protocols, 3) Hiring and termination of ASRS Investment Consultants, Contractors and Vendors, and 4) ASRS Investment Management Policies and Procedures.

Mr. Trachtenberg noted the IC discussed these topics in general at the last IC meeting, and asked for specific comments on the materials. Mr. Harris commented about the asset class committee protocol which does not allow for Board members to vote. Mr. Harris said that there should be an ability to have an asset class matter to go to the IC without vetoing the decision made by the asset class committee.

Mr. Harris also said California Public Employees' Retirement System and Texas Teachers' staff can hire managers up to $500 million. This would allow staff to be more efficient. Mr. Harris said a percentage of the asset class strategy could be used as the criteria. Mr. Dennison added this is very consistent and healthy, particularly with typical opportunistic strategies having short turn-around times of several weeks. Mr. Dokes said he appreciated greater flexibility and pointed out $25 or $50 million could be a typical amount for an opportunistic strategy, where $100-200 million is typical for a stock and bond manager. Mr. Dokes emphasized that the Director and CIO would report the activities of Asset Class Committees to the IC.

Mr. Connelly asked about the current process in private equity and real estate. Mr. Dokes said that currently the Private Equity and Real Estate Committees do not go to the IC for investment selection approvals. Mr. Connelly asked if the Asset Class Investment Committees would report to the IC. Mr. McClory said a decision needs to be made as to whether the Committees report to staff or to the IC. If the latter occurred, the Asset Class Committees would become public bodies subject to open meeting law, which could greatly slow down the process.

Mr. Harris said he is comfortable with the Asset Class Committees if there is proper governance. He would like Townsend and other consultants to report to the Board to ensure this is accomplished. Mr. Harris expressed concern about consultants performing in a biased manner if they report to staff as opposed to the Board.

Mr. Trachtenberg said trustees should not abdicate responsibility, but the question is how to let staff work effectively and not hamper their efforts. It is a matter of how to view the reporting, philosophically and practically.

Mr. Harris said he has a concern in two parts: Asset Class Committee consultants and special project consultants. He was concerned about trustee ability to bring matters of concern to the Board. Mr. Dokes stated that at any time, a trustee would be able to do so. Further discussion ensued regarding checks and balances on the Asset Class Committee(s). Mr. Connelly pointed out that consultants and Asset Class Committee(s) are fiduciaries, having the same fiduciary loyalties and duties as a Board member.

Mr. Harris asked if a matter regarding the consultants was brought to the IC from an Asset Class Committee, would it have to go to the Board. Mr. McClory said it would not. The non-voting IC trustee member(s) of the Asset Class Committee could withdraw their objection if their concern was addressed. Mr. Harris was concerned about a trustee being able to take action regarding a possible issue they had with a consultant. Mr. Matson noted that the trustee would always be able to request that any issue be made an agenda item for an IC or Board meeting. As a result, Mr. Harris felt this addressed his concerns he raised about Asset Class consultants, however, was still concerned regarding issues that might arise with a special project consultant. Perhaps staff could inform the IC of such projects and keep them updated on their progress. Mr. Harris felt it would be sufficient for the IC Chair to be kept informed via a brief phone call. The IC felt that hiring and firing by staff would be fine, given approval of the IC Chair.

Mr. Matson commented regarding special consultants. As a recent example, the CIO had been short-staffed, and budget was not available for a full-time hire. Consequently, Mr. Dokes looked into hiring one of Mercer’s staff to assist. Mr. Dokes noted the importance that investment ideas be originated not just by consultants, but by staff and trustees as well.
Mr. Connelly asked that he would like to discuss the ASRS Investment Management Policies and Procedures further at the next IC Meeting.

Mr. Matson asked if there were any questions upon review of the IC Charter. None were noted. Mr. Trachtenberg said he would like to review asset classes at the IC Meetings and continue to present asset classes with investment managers available to the Board once a year to meet statutory requirements.

Motion: Mr. Harris moved that IC take to the Board sections one, two and three with the additional change of under special project consultants that those are to be approved by the Chair of the Investment Committee. In addition, staff will undertake an analysis and make a recommendation with regards to percentage or dollar allocations, allowing them to make investments with or make investments without approval of the Asset Class Committee.

Section 1: The hiring and termination of ASRS Investment Managers/Partners will be made by four (4) Asset Class Investment Committees: two (2) which currently exist and two (2) new committees. These committees will be the 1) Private Equity Committee (PEC), 2) Real Estate Committee (REC), 3) Public/Private Equity/Fixed Markets Committee (EFMC) and the 4) Opportunistic Investment Committee (OIC).

Section 2: The Asset Class Committee protocol to vote on investments presented to the Asset Class Committee will reside with the Director, CIO and ASRS senior asset class portfolio manager and/or portfolio analyst. The IC Trustee(s) and Consultant are non-voting members. The IC Trustees provide both oversight as well as expertise. The consultant ensures independence and offers expertise. Any IC Trustee retains the right to request that an investment decision be placed on an IC agenda or subsequently on a Board agenda.

Section 3: The hiring and termination of ASRS Investment Consultants, Contractors and Vendors will primarily be predicated on the primary scope of work and the reporting protocol associated with the subject matter for which they are engaged by ASRS.

Mr. Jim McLaughlin seconded the motion.

By a vote of 4 in favor, 0 opposed, and 0 absent, the motion was approved

5. Call to the Public

No members of the public requested to speak to the IC.

The meeting adjourned at 2:50 PM.

Respectfully submitted,

Lisa Hanneman, Secretary	Date	Gary R. Dokes, Chief Investment Officer	Date